

Upside Down: Strange Mortgage Market Frustrates Banks (August 2010)

That's how bankers view the residential mortgage market, where new rules and a growing wave of strategic defaults frustrate their efforts to lend.

By Melanie Scarborough, contributing editor

Homeownership, the cornerstone of the American Dream, has become the American Nightmare for many: mortgage-holders watching their home values plummet, applicants facing tough qualifying standards, and bankers who would like to lend but are struggling under regulatory constraint.

The National Association of Realtors reported that contracts for pending sales on existing homes plunged 30% in May. While that likely was caused by the expiration of a tax credit for first-time buyers, the fact that the sales rate dropped more than twice what economists predicted suggests other factors are in play.

Certainly, high unemployment and a shaky economy reduce the number of mortgage applicants. But even areas with the most stable housing markets report problems making loans.

Money available, but only for a few

Oklahoma has the lowest percentage of homeowners with negative equity—only 5.9%, compared to the national average of 23.7%—according to a recent survey by California-based CoreLogic. Yet Brad Swickey, president and CEO of Valliance Bank in Oklahoma City, says the state's steady mortgage market doesn't immunize them from problems because banks are subject to the national underwriting standards of Fannie Mae and Freddie Mac.

“What drives housing values is the availability of financing,” Swickey says, and financing is increasingly hard to obtain. “Everyone hears the mortgage rates quoted as being at historic lows, but those rates are offered only to individuals with a middle credit score of about 740.” Consequently, the moderate-income family with a score around 650 often is priced out of the market, frustrating them as well as their bankers. “I'm not saying mortgage money isn't available; it is,” says Swickey. “But it's not freely available for people with good, solid jobs and good, solid credit scores who are finding it more difficult to qualify than they would have two years ago.”

Exacerbating the problem is examiners' demands that banks have more capital on hand. For a \$200 million-asset bank such as Valliance, that means reducing the number of assets on its balance sheet. I would love to make loans,” says Swickey, “but examiners want more capital. So I have to buy government or agency securities at 2-3% when I'd rather make loans at 6-7%.”

Big hit from new rule

In another small community, Placerville, Calif., El Dorado Savings Bank FSB faces a similar situation. The bank has very few delinquent loans and foreclosures because, as a portfolio lender, it underwrites conservatively, explains Thomas Meuser, chairman and CEO of the \$1.7 billion-asset bank.

The local mortgage market saw an uptick earlier this year as people applied for mortgages before the tax credit expired, but activity has slowed significantly since then and more trouble may be coming. "There's a real concern that banks have held back on foreclosures, and those will be coming online the second half of this year," says Meuser. "So we will have a difficult year at the end of this year and into 2011."

But like Swickey, he sees new regulation as the long-term danger. "The new rule [contained in the Dodd-Frank regulatory reform act] that we have to verify that people can make payment is going to be a real hit to the housing market because we make a lot of loans—and have for our 50-year history—[on the basis] that a person is a good risk," says Meuser. "On paper, maybe they don't look that good, don't have good qualifying ratios, but we make the loan anyway."

Such applicants usually are long-standing customers with good credit scores who may be self-employed or do the sort of work where a consistent income is difficult to verify. "We know they can pay," he says, "but we aren't going to take a chance on them going forward because of potential liability." The new rules also will force El Dorado Savings to make fewer of the CRA loans that earned it an outstanding rating in the past.

Lawmakers think they're protecting the borrower, but they're actually making it more difficult for people to get loans, observes Meuser. "It's a huge deal that hasn't gotten much attention."

Customers say, "I'm outta here"

One huge deal that is drawing attention is the problem of strategic default: the growing number of mortgage-holders choosing not to make payments even though they have the means to do so. Researchers at the University of Chicago and Northwestern University estimate that such calculated decisions now account for about one-third of all home-mortgage defaults. The phenomenon is particularly prevalent in areas where home values have dropped 25% or more.

"The real star of the show is the person with a \$1 million house now worth \$600,000 who decides it isn't worth it, that there are other things he can do with his money," says William Uffelman, president and CEO of the Nevada Bankers Association. In that hard-hit state, 70% of mortgages are upside down.

Fannie Mae recently announced that it will deny government-backed mortgages for seven years to borrowers deemed to be strategic defaulters, but that is unlikely to deter underwater mortgage-holders who can save thousands of dollars each month by walking away from their loans. "If you're a person of means who has other places to go or a second home and have no credit needs, so what if your personal credit takes a hit? You have a place to live at a lower price," Uffelman says. "Lots of them will look at you and say, 'It's just a business decision.'"

Indeed, few of the strategic defaulters seem to think they're doing anything wrong. Many underwater mortgage-holders say it is irrational to pay for a crisis they didn't cause.

In Arizona, the heat is on

Strategic defaults now account for 20-35% of defaults in its state, the Arizona Bankers Association estimates. "We've got cases of higher-end homes where the bank can see [customers] have money sitting in the bank that would satisfy the loan," says Tanya Wheeless, president and CEO of AZBA.

Yet Arizona bankers are greatly disadvantaged by the state's unique anti-deficiency statute. "Banks can't go after homeowners on their primary residence, a second home, or any investment property," she explains. "Our feeling is that has contributed considerably to the high rate of default—particularly in a state like ours where values are down on an average of 25-40%, depending on location."

In one case, a borrower from the Midwest bought a \$1 million vacation home in Paradise Valley, Arizona's wealthiest ZIP code, but decided he no longer wanted the property after its value declined. To get the benefit of the anti-deficiency statute even though he had never moved into the house, "he flew in and camped out in the home for about a week and claimed it as a residence," Wheeless says, before returning the keys to the small community bank that held the mortgage.

In addition to lobbying strenuously for a change in law, the Arizona Bankers Association urges its members to have long memories. "When credit turns around, it's going to be important that bankers remember who those folks were who walked away," she says.

Yet as lenders become more suspicious, chiselers get more canny. Wheeless recently heard someone at a social gathering blithely talk about their plan to default strategically and says if the lender asked any questions, they would say they were buying the second home for a parent.

"You go from being shocked to appalled to angry," says Wheeless. "Foreclosures of all types affect everyone else. I keep waiting for the masses to revolt and say, 'You're hurting me and my land value.'"

The good news is that Arizona's residential values seem to have stabilized and are even climbing in some areas. As that trend continues, Wheeless expects strategic defaults to decline. "We'll still have foreclosures driven by lack of income," she says. "But strategic default is different because there's a choice."

No shade in the Sunshine State

Banks in Florida can file deficiency judgments and many are doing so with a fair degree of success, reports Miller Couse, president of First Bank of Clewiston. "You might not get your money back right away, but in the next ten years you'll be able to get some of that money back," he says.

The process is easier for community banks that made direct loans. Government lenders commonly take 18 months to two years to begin foreclosure proceedings—a factor strategic defaulters apparently take into account in deciding to stop making payments.

Experts fear that as that knowledge spreads, strategic defaults will accelerate, putting more vacant houses on a market already overburdened by inventory.

Couse admits to being baffled by such behavior: "It's been quite shocking to us to watch this happen." Because First Bank didn't make any stated-income or zero-down loans, strategic defaulters are walking away from at least 20% equity.

Like other bankers, Couse must cope not only with fickle customers, but with an uncertain mortgage market. "Every month we think we've touched bottom and then things slip a little more," he says. "We're certainly not having the devaluation we did have—but as these foreclosures keep coming on the market, home prices go down. It's just such a crazy time."

That seems to be the consensus. Nationwide, bankers expect their markets to rebound, but see new hurdles on the road to recovery. —

From rust to riches

In contrast to the national trend, home foreclosures in Pittsburgh slowed last year by nearly 8%, with Forbes naming it the best city in the country to buy a home. So what is The Steel City doing right?

Part of it is luck. "If you attribute the housing crisis to rapid appreciation that couldn't be sustained, we didn't experience that in Pittsburgh," says Mike Henry, vice-president of residential lending for Dollar Bank.

The city is not immune from what is happening in the rest of the country, he says, but it has not experienced the underwater mortgages that led to catastrophe in other areas. "Affordable housing brings companies into the area, and that helps sustain stability. We've seen decent growth."

Another safeguard from the housing crisis is that Pittsburgh is not overdeveloped. Additionally, Pittsburgh is not a high-transient city; most residents buy homes with the intent to stay in them.

Finally, Henry says, Pittsburgh is not experiencing the high unemployment that plagues other parts of the country—and a stable employment rate "helps sustain a nice, healthy housing market."

ABA expands relationship with Wells

Community Bank Mortgage LLC, a mortgage cooperative that operates as a subsidiary of the ABA, renewed its relationship in June with Wells Fargo Funding Inc. to act as a secondary market investor for loans originated by the 55 community bank owners of CBM. Then, in July, CBM announced that it had selected Wells Fargo Funding as its newest mortgage solutions provider for secondary market sales of residential mortgages. Under this expanded arrangement, Wells will offer all eligible ABA member banks a full range of products and services.

For more information about the program, go to www.aba.com/mortgagellc or contact Deborah Whiteside, president of CBM, at 1-800-BANKERS, ext. 5580.

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